Can China

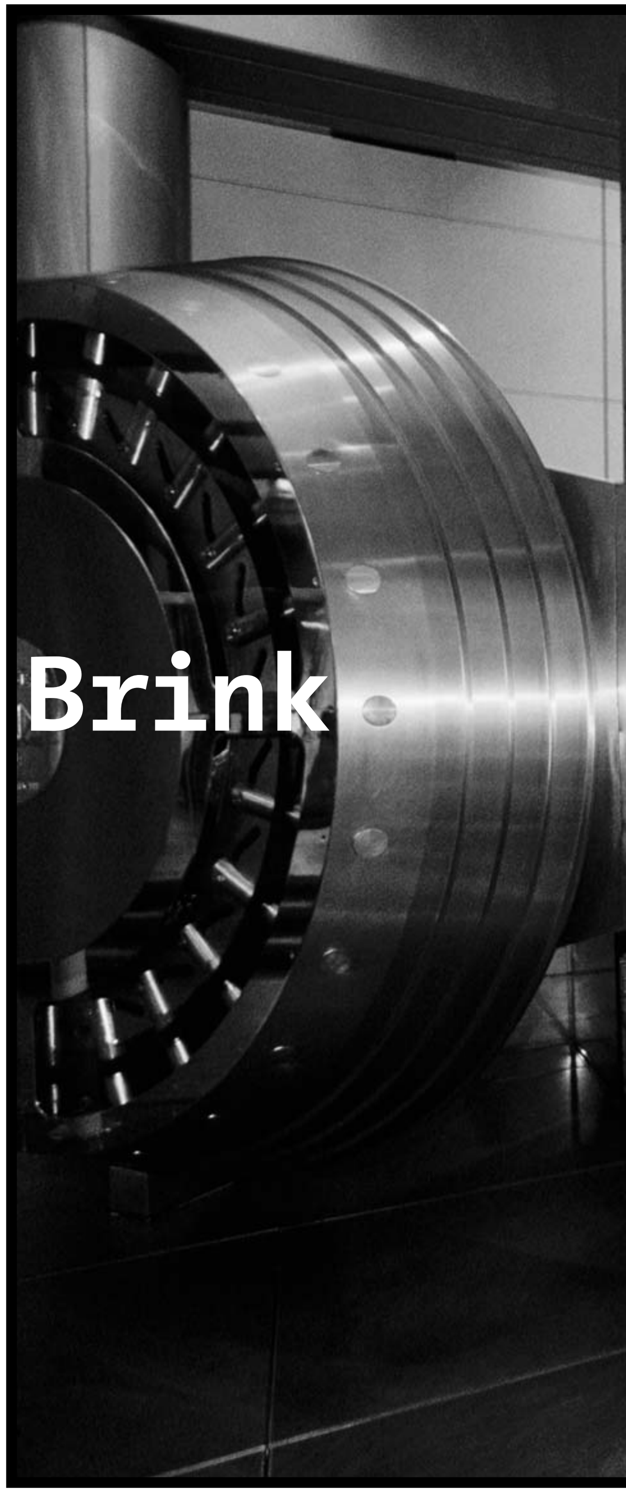
Fix its

Banking

System?

Reformers at the Brink

by Marsha Vande Berg



China's new rulers are circling around what could prove the toughest challenge of their reign – reform of the state-run banking system and the crony Socialist system for allocating capital. They are taking steps to repair the balance sheets of major banks, which are groaning under the weight of billions of dollars in dud loans. And they must manage the process in ways that sustain the credibility of the Communist Party.

It didn't help, of course, that Beijing

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has had its hands full coping with the SARS epidemic, which hit China just weeks after the change of government. Nor did a less-reported event (though one more relevant to the financial challenge): a bank-corruption scandal that spread from Hong Kong to Shanghai. There is little reason to believe, though, that either will sidetrack the reform effort.

In fact, the bank scandal could work to the reformers' advantage, promoting awareness that the key to modernizing the economy is to limit political interference in the banking system. "These are short-term crises. They're opportunities to make improvements, including the transparency of loan processing," argued a portfolio manager with Matthews International Funds in San Francisco.

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Uncertain times also afford the government an opportunity to switch its focus to banking reform and away from last year's preoccupation with the equity markets – the latter viewed by some as "casino capitalism." To this end, the new leadership has created a bank regulatory commission, placing Liu Mingkang, a respected bureaucrat with a reputation for intolerance of corruption, at the helm.

The new energy behind reform could also lead to a third infusion of capital to shore up China's Big Four commercial banks (the Bank of China, the Industrial and Commercial Bank of China, the China Construction Bank and the Agricultural Bank of China) along with the transfer of nonperforming loans from the banks' books to special "asset management companies." These companies, set up in 1999, are similar in function to the government agency that collected the low-grade

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assets from bankrupt institutions during America's savings and loan crisis in the 1980s.

To date, the Big Four have transferred loans and stock with a nominal value of a whopping $169 billion to four asset management companies. Purchasers of chunks of these assets (at huge discounts, of course) include Goldman Sachs. There is also a plan to set up similar asset-transfer entities to bury nonperforming loans on the books of companies owned at the provincial and local levels.

Yet, despite the range of reform-related activities, the government is still poking around the edges. "Instead of persisting with the present 'muddling through' approach, China's new leaders should go for a 'big bang.' Otherwise the flourishing economy that they have inherited could soon find itself in trouble," Fred Hu, managing director of Goldman Sachs, explained in an article published in *The Financial Times.*

For Beijing, the issue seems to break along two lines. On the one hand, the leadership is committed to driving reforms in order to defend the legitimacy of Party-controlled government. On the other hand, it is deeply reluctant to upset the status quo – especially in ways that alienate the Party's core supporters in northern industrial cities, where tens of millions of jobs still depend on the viability of state-owned enterprises.

Loans currently on the books of the state-owned banks exceed $1 trillion. Of that total, the government says, roughly 25 percent are non-performing. Outside estimates suggest the percentage of non-performing loans could be as high as 50 percent, but at least everyone agrees the figure is dropping.

Some argue that the situation is not as grave a threat to China's payments system (and ultimately, China's drive for prosperity) as it first appears, because the Chinese government guarantees most of the bank debt and has considerable assets (not to mention the power to print money) to make good on bank liabilities. However, failure to clean up the banks' balance sheets could damage the confidence of foreign investors who poured $52 billion (along with vital industrial technology) into the Chinese economy last year in the form of direct investment.

More fundamentally, business as usual will undermine China's long-term growth prospects, because state-owned banks continue to direct valuable capital to state-owned enterprises, however inefficient. Indeed, it is a mistake, in the view of Linda Tsao Yang, a former governor at the Asia Development Bank, to view the Big Four banks – with 80 percent of the market – as real banks. "In principle, yes, they were set up as banks," she said. "But in recent years, especially with the opening up

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under the rules of WTO, their real function is to avoid a massive loss of jobs. Any change, no matter how desirable, if it's seen as upsetting, will trigger an effort to slow reforms down," she added

Meanwhile, the clock continues to tick on China's obligation to meet accession terms with the World Trade Organization. The phase-in period is scheduled to expire in 2007, at which time a liberalized Chinese economy, including the reformed banking sector, is expected to open up to foreign competition. At that point, foreign banks will be able to lend and take deposits, denominated in Chinese currency, from Chinese individuals and firms – which they now are barred from doing. If China's state banks are still sitting on a mountain of bad debts when the deadline rolls around, they will be in no position to hold onto the deposits that have thus far allowed them to scrape by.

The creation of the regulatory agency with Liu in charge is certainly a promising step toward fiscal daylight. However, a close look at the agency's structure suggests that its prospects for success still depend on a decisive break with the legacy of China's socialist past. And such change would be quite a stretch for an institution so tightly linked to the banking establishment.

Ostensibly, the regulatory agency has taken over the central bank's direct regulatory function, leaving the People's Bank of China with responsibility for monetary policy. That independence seemed critical if bank regulators were to challenge the power of the banks.

But something slipped 'twixt cup and lip. At the time of its founding, the agency was also charged with managing the personnel of state-owned banks. This had been the responsibility of the Central Financial Work Commission, an entity set up by the then-premier, Zhu Rongji, and run by Wen Jaibao, then vice premier and now premier. The commission's authority flowed from the government.

It is far from clear that a reform agency with bank management responsibilities can work effectively to decentralize authority in ways that allow it to operate effectively in a competitive market. On the other hand, this is China, which does things its own way. The development of the agency along these lines simply illustrates the nature of the reorganization that is underway, says Barry Naughton, a China specialist at the University of California at San Diego. It's indicative of "government reorganization in general: deliberate, delayed and complex, yet still moving," Naughton wrote in a recent issue of the online *China Leadership Monitor*.

But can it succeed? The institutional history of the banking sector offers clues. Today's banking system emerged from a highly centralized unitary banking institution that was both a central bank (with authority to issue currency and implement monetary policy) and a commercial bank, providing deposit, loan and settlement services.

The PBC was established in 1948, when three regional banks were assembled under

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the control of the Chinese Communist Party. The new entity worked with the Ministry of Finance under the State Planning Commission to sustain party control, following guidelines set by Beijing's central planners. It not only ran the banking system, but served as insurance regulator and underwriter.

In the mid-1950s, the banking sector expanded along with the Chinese economy. The Bank of China was set up under the PBC, while the People's Construction Bank was formed under the control of the Ministry of Finance. The Bank of China was responsible for foreign-exchange activities, while the Finance Ministry supported domestic construction and other fixed investment. Rural Credit Cooperatives were also created to take deposits and allocate funds in China's diverse agrarian economy.

Both the Bank of China and the Construction Bank were run as departments within government agencies – as opposed to independent entities – until the reforms of late 1983 and 1984. At that point, Beijing began to regard the PBC as its central bank.

From the beginning, these banks operated within numerous non-market constraints. Party officials and bureaucrats, as well as the formal government authority, looked to the banks to support the industries and enterprises that supported the ruling elite. And in some senses, not much has changed: local officials' fate remains tied closely to the survival of state-operated businesses in their jurisdictions.

Any restructuring in the financial sector, then, has the potential to interfere with party patronage and government control at the grass-roots level. And that is bound to be painful in a system devoted to busywork. Management reforms in the state banks alone cost 300,000 jobs in the late 1990s.

But others will benefit greatly from the opening up of the buttoned-down system.

For example, even the modest shift to date in lending that favors consumers, especially in the areas of home mortgages and automobile purchase finance, has resulted in a mini-boom for second-tier commercial banks.

These second-tier banks, which include shareholding banks with less than 15 percent foreign ownership, are majority owned by local governments or state-owned entities. The exception is China Minsheng Bank, which is majority owned by the Orient Group conglomerate. Minsheng's net profit jumped 43 percent during the first quarter of 2003, to $34 million, largely because of its success in financing private auto and housing ownership.

Shareholding banks tend to avoid loans to state-operated businesses, which means their portfolios are likely to be in much better shape than those of state banks – as is the case with Minsheng Bank. A recent report by the London-based Royal Institute of International Affairs speculated that these shareholding banks will merge and acquire urban banks – of which there are about 100 – to expand their branch networks.

While these smaller Chinese banks welcome foreign investors with open arms for the expertise they bring to technology and management, foreign banks have more ambitious plans. They are eager to position themselves to leverage their investments in the core of the banking market, once the reins come off in 2007.

Notable examples include HSBC Bank, which bought an 8 percent stake in the Bank of Shanghai in late 2001, and Citigroup, which purchased a 5 percent stake in Pudong Development Bank in early 2003 and subsequently obtained an option to increase that holding to a controlling interest in the future.

Foreign investors are being allowed to compete, but based on rules – some of which are very rigid – designed to ensure that foreign banks do not destabilize the sector. "It's a matter of having been in the market in China for a long time," says a high-placed Citigroup official. "We're trusted. We have a reputation of seriously supporting China in the global economy."

In contrast to the arrangement in Pudong, an investment in the Shenzhen Development Bank by Newbridge Capital, an American equity firm, now appears to be in limbo after Newbridge's China partners booted a management committee made up of Newbridge representatives. The partnership is now the subject of a lawsuit brought by Newbridge in a federal court in Texas against Taiwanese interests, alleging they interfered in the arrangement with Shenzhen Bank.

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At the time it was announced, the Newbridge deal was heralded as a breakthrough in United States-China joint ventures and as a sign that China was committed to increased Western participation in the banking sector. And some now view the developments around the Newbridge investment as an important setback to foreign investors' confidence in doing business in China.

But others dismiss the unraveling as an

anomaly rather than a harbinger. They point to the corruption investigation into one of China's wealthiest individuals and his relationship with the Bank of China (Hong Kong) that erupted in June as off-putting to Western business. "The scandal definitely will hurt investment sentiment, at least in the short term," said the portfolio manager with Matthews International Funds. In the longer term, progress with reforms will overtake these kinds of problems, he added.

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As is often the case in today's China, change can hinge on the influence and stature of a single individual – in this case, Liu Mingkang. Liu recently announced that he intends to secure a 3 to 4 percent improvement in the ratio of bad loans to GDP in the next several months. He made the announcement in an unusual setting for a Chinese official – a press conference.

Liu brings a great deal of credibility to the table. In the past, he has been put in charge of banks when corruption scandals threatened to destroy credibility in the banking system and undermine the authority of those who sit in Beijing. Three times, he oversaw massive cleanups – including twice at the Bank of China.

In 2000, he was named chairman of the Bank of China, succeeding Wang Xuebing, whose banking career imploded spectacularly following United States regulators' claim of improper banking practices at the Bank of China's New York branch. The following year, Liu restructured 13 affiliated Hong Kong branches of the Bank of China as a coherent unit, which subsequently became Bank of China Hong Kong.

In July 2002, he shepherded through a public offering of Bank of China Hong Kong on the Hong Kong stock exchange. The offering was successful, raising $2.63 billion when the parent, Bank of China sold 22 percent of its ownership. At the time, the auction was watched as a trial run for stock market listings of three of the Big Four banks, including the Construction Bank of China and the Industrial and Commercial Bank, by 2005.

Liu was quoted by Bloomberg as believing that "time is running out for the banks." If he is to succeed with his stated intention to cut the ratio of non-performing loans at China's big banks, he will need the cooperation of other reformers in Beijing and throughout the provinces.

If time is indeed short, China's reformers will have to ask themselves why they squandered valuable momentum. But even if Liu is just posturing, the government will have to figure out ways to keep political interests at bay while it brings the county's system for allocating capital into the 21st century. The country's future – not to mention the future of the Party – depends on it. M